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PARRALLEL FOREIGN EXCHANGE MARKET AND INTRA-REGIONAL TRADE COOPERATION

I. INTRODUCTION

1. The Lagos Plan of Action and Final Act pay particular attention to intra-regional trade cooperation by providing for 1/ the implementation of a very complete programme of long-term economic cooperation mechanisms among African countries with a view to meeting their needs in the areas of trade, production of foodstuffs, minerals, manufactured goods, improvement of the means of transport and communication, etc. The success of this programme should lead to an intra-regional trade cooperation policy.

2. Nonetheless, the implementation of this programme is still confronted with some difficulties among which an inadequate control of economic power 2/ and especially by the existence of a system of payments and renumeration of factors inherited from the functioning of the international monetary and financial system. Another obstacle to the emergence of an optimal trade-cooperation situation is the existence of parallel foreign exchange markets which undoubtedly result from permanent foreign exchange crises and the accompanying lack of supplies. These crises somehow compel monetary and financial authorities to require prior authorization for all foreign exchange transactions.

3. But, this control usually does not have any impact in a period of extreme shortage and inflation which characterize African economies. On the contrary, it worsens the problems caused by the overvaluation of the official exchange rate and favours the disintegration of market mechanisms 3/.

4. The disintegrated mechanisms will give rise to a parallel foreign exchange market with its perverse impact on intra-regional trade cooperation. That is the content of this paper of which the main points are the following:

1/ See ECA, The Role of Commercial Banks in the Development of Trade among Central African Countries, Doc. E/ECA/TRADE/1 para. 1.

2/ See Mike Faber and R. Herbold Green, «Le malaise économique de l'Afrique subsaharienne», dans OCDE, Afrique subsaharienne de la crise au développement, Seminars of the Development Centre, OECD, 1985, p. 16-30.

3/ See Pierre DUPRIEZ, Contrôle des changes et structure économique, Paris: Mouton et IRES, p. 33-52 World Bank, Report on World Development, 1987, ch. 7, p. 131-152.

I. Definition of the parallel market

II. The causes of the parallel market

III. The economic impact of the parallel foreign exchange market

IV. Parallel foreign exchange market and intra-regional trade cooperation

V. Measures for controlling the parallel market

VI. Conclusions and recommendations.

II. DEFINITION OF THE PARALLEL FOREIGN EXCHANGE MARKET

5. The parallel foreign exchange market is a clandestine market on which foreign exchange transactions 4/ are carried out by violating the law. This market rises from the failure to meet the demand for foreign exchange on the official market where it is limited by the rules of exchange control. Such a market does not need a precise geographical setting; while it is forbidden in principle within the country, it is practically free beyond the borders. Well organized, the parallel market is impervious to any administrative control. It can operate through simple private clearing and part of the accounts are kept outside the country while the other part can be easily hidden under trade and real estate transactions.

6. It is thus a market that exchange control and the lack of foreign exchange turn necessarily into a buyer's market. As a result, the exchange rate on this market is higher than the official exchange rate.

III. THE CAUSES OF THE PARALLEL FOREIGN EXCHANGE MARKET

7. The main cause of the parallel foreign exchange market is the transfer to foreign exchange of the normal functions of the national currency, that is the functions of trade intermediary, unit of account and reserve of value.

8. When an exchange control regime is established, the bank authority imposes restrictions on imports. These restrictions are in the form of rationing or quotas which limit the volume of authorized imports in order to reduce foreign exchange expenditure. By limiting imports, exchange control will already bring about excess demand compared to supply 5/.

4/ Some economic agents often classify the most diverse measures and the most varied regimes under the term parallel market. When, one talks about the free market, the black market, smuggling but all these terms are not always identical even though the facts they imply are interdependent.

5/ P. Fontigny, "Note sur quelques effets des contingentements et des taxes d'importations" in Bulletin de l'IRES, Louvain, vol. VII, 3 May 1936, p. 367-399.

9. If demand can only be met by imports, exchange control will have a direct impact on supply and, through rationing, it will limit the quantity of goods supplied to the market. The existence of some supply rigidities will lead to new excess demand which will be reflected, on the black market, by a rise in prices higher that the one which would exist on a perfectly fluid market. Permanent excess demand will be met by imports of goods financed by purchasing foreign exchange on the parellel market.

10. The national currency gradually ceases to fulfill its trade intermediary and unit of account function. In fact, it does no longer allow one to buy any good and numerous goods can be bought only with foreign exchange. Thus, more than the national currency, foreign exchange is demanded to satisfy that motive for transaction which Keynes 6/ defined as «the need for liquidity» for the current realization of personal exchanges and trade. Since the national currency only imperfectly fulfills its trade intermediary role, the money function tends to shift from the national currency to foreign exchange.

IV. THE ECONOMIC IMPACT OF THE PARALLEL FOREIGN EXCHANGE MARKET

11. Henceforth, it becomes logical to use as money the instrument which serves as trade intermediary. This is encouraged by the uncertainty which surrounds the issuing of licences for imports which are necessary for amortizations or simply for the normal functioning of the firm. Any economic calculation in the national currency becomes extremely uncertain 7/. Entrepreneurs and businessmen begin to evaluate their activities by referring to the foreign exchange value of the goods which they supply to the market.

12. With the appearance on the market of a parallel exchange rate for foreign currencies, the national currency loses its value reserve function. The motive for cautiousness as the motives for speculation and transaction increase foreign exchange demands. Holding part of cash abroad protects the owner against the future deterioration of the national currency and allows the speculators to profit from the appreciation of foreign exchange 8/.

13. These three motives (caution, speculation and transaction) will transform the demand for money into a demand for foreign exchange which cannot be entirely met by the official market which is limited by exchange restrictions.

6/ J.M. Keynes, The General Theory of Employment, Interest and Money, London, 1957.

7/ H. Leclercq, «Analyse générale de l'inflation congolaise», Cahiers économiques et sociaux, I, 1st October 1962, p.25.

8/ See André Page, Monnaie, répartitions et relations internationales, Paris Daloz, 5e édition, 1986, p. 163.

14. This schematic reasoning allows us to say that resort to the parallel market starts off a cumulative process. 9/ In fact, the national currency on which speculators' pressures are exerted, will fall off its parity because of intense pressures by foreign exchange buyers. And, at the same time, foreign exchange will appreciate and widen the gap between the official parity and the parallel market exchange rate. The gap between the two rates will reinforce inflationary pressures. As a result, prices and the profits made by middlemen and importers will rise. Trade profits will increase further the demand for foreign exchange, and monetary income from the sale of foreign exchange on the parellel market will, in turn, hike the demand for goods and services.

15. Once the cumulative process is started off, there is no one single parallel market but there emerges a whole parallel economy which will live as a parasite on the legal economy. Informal economic and trade relations will supersede the official networks. Clandestine activities and operations aiming at making profits out of the shortage of supplies, will grow faster than the official trade and intra-regional trade cooperation will be affected by these developments.

V. THE IMPACT OF THE PARALLEL FOREIGN EXCHANGE MARKET ON INTRA-REGIONAL TRADE COOPERATION

16. The main difficulty in intra-regional trade cooperation in Africa is by far fixing prices and determining appropriate exchange rates for numerous national currencies. 10/ In a country where the parallel foreign exchange market is prosperous, these difficulties are exacerbated further by the fluctuation of the prices of imported goods and, in particular, of current consumer goods and luxury goods. The situation is even more delicate for primary commodities of which the prices are difficult to fix in advance for a long period with some chances that the two trading parties would be finally satisfied by the result. It is the resentment caused by the gap between the prices expected and the prices effectively paid which will serve as a catalyst of the parallel market operations and perturb seriously enough the trade relations between the contracting parties.

17. In a normal situation, intra-regional trade cooperation relations aim at correcting this resentment by increasing official trade 11/ financed by a clearing system which uses the currencies of the member countries. The

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9/ P. Dupriex, op.cit., p.100.

10/ Among other difficulties, we may cite the role of transnational corporations, the lack of trade information, customs duties and other restrictions, insufficient financing, etc. See ECA, Development and Expansion of Intra-African Trade, E/ECA/TRADE/85. See also ECA, The Establishemnt of an African Monetary Fund: Structures and Mechanisms, technical feasibility study, para 15.

11/ See the proceedings of the 2nd colloquium on the economic integration of West Africa, Conakry, 1980, p. 243.

realization of this objective requires the harmonization of trade policies as well as the coordination of the customs, monetary and fiscal policies of the contracting countries. 12/

18. But, resort to the parallel market breeds a feeling of defiance towards the national currency, which is fuelled by the most diverse sources such as the position of external payments, a confused internal financial situation, an uncertain political climate, the alleged designs of the governments, etc. 13/ This climate will be maintained by the economic agents who want to accumulate capital in foreign exchange abroad.

19. The behaviour of these economic agents will maintain speculative operations through capital flight for security reasons or by anticipating profit based on the depreciation of the national currency. 14/ For these feelings to be satisfied, economic agents will set mechanisms for going around the law and official regulations governing trade in goods and services. 15/

20. Arrangements will be violated by fraudulent practices favouring and financing smuggling, illicit imports, misappropriation of transit trade, non repatriation of export earnings. These illegal transactions which are not recorded, will have a great negative economic impact on the countries in which they are carried out and will therefore gravely disturb trade cooperation relations.

(a) Smuggled goods

21. With the parallel market, the smuggling of goods develops and is carried out on the basis of a tacit agreement between suppliers and buyers on both sides of the borders of neighbouring countries on the types and quantities of goods and the modes of payment. The means of payment are not related to the official exchange rates.

12/ See also ECA, Bilateral Trade and Payments Agreements Concluded in Africa, Doc E/CN.14/STC/24/Rev.1

13/ Andre Page, op.cit., p. 462

14/ For P. Dupriez, op.cit. p.99 "The national currency is now only very imperfectly choice power because its holder does no longer have the full freedom to choose the good that he wants to buy. Besides, the three motives for transaction, caution and speculation argue for foreign exchange cash holdings and the convergence of these motives is enough to transform partially demand for foreign exchange".

15/ Practically all the bilateral agreements always include a clause which stipulates that "the two contracting parties must support and facilitate between themselves and within the limits their laws and regulations the widest trade in goods in accordance with the examples contained in the list appended to the agreement or relating to other items which are not explicitly mentioned". (E/CN.14/STC/24/Rev. 1 para 11).

22. The goods which are smuggled, are generally imported goods but they may also be livestock 16/ or local products. These transactions often lead to a substantial loss of ressources for the countries concerned and deny them an important source of foreign exchange 17/, distort clearing relations and cause the treasury to lose tax receipts. This is due especially to falsifications of documents and false declarations.

(b) Falsification of documents

23. The products financed by the parallel market have the characteristic of being accompanied by false documents. These practices take two forms falsification of documents and creation of false documents. Falsification implies the presentation of false information relating to quality, value, type and quantity of exported and imported goods. Falsification may be done by deliberately through deliberate alterations of figures, omissions and calculation errors in official trade documents such as invoices, customs declarations, bills of leading and insurance documents.

24. Fabrication of false documents is a more serious practice in so far as it is very well organized and cannot therefore be detected easily. In a parallel market, a fabricated document inevitably leads to distortion of information relating to goods and generally favours theft and smuggling of imported consumer goods such as television sets, radios and other electronic equipment, spare parts and other which are paid for in foreign exchange and sold in local currencies in neighbouring countries.

(c) Misappropriation of transit trade

25. It appears from practices that the parallel market by favouring smuggling, also misappropriates transit trade. Then, trafficked products are brought into a country not to be consumed but to be transferred and reexported fraudulently to other countries in order to earn foreign exchange. 18/

(d) Loss of earnings

26. Import and export taxes are quite obviously not paid on smuggled goods, which constitutes a loss of earnings for the countries concerned. Given that most of the African countries earn a good portion of their income from customs receipts and indirect taxes, large-scale smuggling to or from one country may have serious consequences on public finance. For most countries, the loss of earnings is a serious problem which has serious repercussions on their efficiency in economic management.

16/ ECA, Unrecorded Border Trade among African Countries, Preliminary note by the Secretariat, Doc. E/ECA/TRADE/80, para 10. ECA, Ibid, para 15.

17/ In some border areas transactions are carried out in foreign currency, notably in dollars or in pound sterling. The evaluation of duties is not based on any official document.

18/ ECA, E/ECA/TRADE/80, para 15. "Precise examples are notably used clothes from Rwanda sold in the border areas with Uganda and Kenya and gold smuggled from Zaire is sold on far-away markets, notably in the Middle East. Coffee is another commodity which is smuggled into one country and reexported abroad to earn foreign exchange.

(e) Foreign exchange flight

27. The flight of resources from an exporting country is another important aspect of the parallel market. It takes place when a considerable portion of basic commodities is smuggled abroad because of the price differential with neighbouring countries. The loss suffered by the country is therefore calculated not only in terms of earnings but also in terms of foreign exchange because the smuggled commodities are generally paid for in local currencies. Some countries also suffer losses of foreign exchange on the goods smuggled out of their territories because the goods which are smuggled out, were initially imported and paid for by them in foreign exchange through the official channels.

VI. MEASURES FOR CONTROLLING THE PARALLEL MARKET

28. All the measures which may be proposed to resolve the parallel market problem have to include a sound management of exchange and prices policies.

29. The fact that some currencies are exchanged up to ten times less than their official rates reflects a serious imbalance in their purchasing power compared to the currencies of the neighbouring countries. If in country A a product is sold at the equivalent of ten dollars and if the same product is sold at the equivalent of one dollar in country B, we are in a situationof overvaluation of the curency of country A. In the case of the parallel market, this situation will lead to an exchange rate reflecting a de facto devaluation of the currency of country B which will have only one tenth of its value. This example is not necessarily a typical case but in numberous situations, some national currencies may depreciate by 200 to 300%, which requires for the currencies concerned an appropriate adjustment in order to arrive at a realistic exchange rate whish would no longer encourage traders to smuggle goods.

30. Price fixing policies which create large disparties with the prices in force in neighbouring countries constitute a great incentive to the parallel market. It is worth noting that in some areas, price differentials are an important cause of the smuggling of commodities such as coffee and cocoa as well as foodstuffs such as maize, millet, sorghum, cassava and others. The price fixing policy should generally take into account other factors such as the streamlining of the collection and distribution of food crops within the country, the strengthening of the efficiency of marketing and cooperative bodies, the improvement of transport systems and speeding up the payment of producers. Improvements in these areas would contribute to reducing considerably the volume of smuggling and, therefore, its source, the parallel market and vice versa.

(a) De facto legalisation of border trade

31. There is, in numerous border areas, a de facto situation in which border populations of both countries trade with each other with the tacit agreement of the governments concerned. The populations are authorized to cross the border and to buy small quantities of commodities which are imported duty-free. This trade, however, is not recorded. Some countries create official trading posts where products are sold to the population of the neighbouring country and paid for in local currency at the official exchange rate.

(b) Harmonization of tariffs

32. The adjustment of tariffs is an important way of resolving the problem of illegal trade. Some countries charge high customs duties on some categories of products, in particular the so-called luxury items such as electronic appliances, alcoholic beverages, jewellery, perfume, etc. in order to discourage their importation so as to save the scarce foreign exchange of these countries. Other consumer goods are also subject to high taxes in order to protect the local industries. These products are smuggled in order to avoid paying these high customs duties as well as to go around red tape and the need to obtain a certificate from the monetary authorities. Agreements on the reduction and harmonization of the tariffs of neighbouring countries where wide-scale smuggling of these products exists, may reduce this activity, promote normal trade and cut down the activities of the parallel market.

(c) Production and supply of essential goods

33. The shortage on the local market of consumer goods and essential goods is another reason for illegal trade. It has been contended that the smuggling of these products allows in this case to meet a persistent demand which cannot be met through official channels. The authorities could fight against the smuggling of these products by adopting appropriate policies with a view to increasing production and insuring regular and continued supply.

VII. CONCLUSIONS AND RECOMMENDATIONS

34. As it appears from this analysis, the parallel market is manysided and may involve all the types of products, goods and services. The reasons for this market have been examined even though not all the ramifications of the problem have been analyzed.

35. It has been shown that the existence of the parallel market is harmful to intra-regional trade cooperation by praising smuggling and financing illegal trade.

36. While the base of trade cooperation is the expansion and diversification of countertrade, the parallel market owes its success to shortage, fraud and falsification.

37. The parallel market widens the gaps in the trade and bilateral payment balances, destabilizes markets and prices.

38. Since the loss of earnings, the flight of foreign exchange and the economic distortions that the trafficking of foreign exchange causes on the parallel market, have interdependent causes and consequences, they undoubtedly affect the good-neighbourliness and trade cooperation among States.

39. The main issues to be resolved are therefore adequate supply of markets in general consumer goods and in essential products, appropriate investments in production sectors, the establishment of realistic exchange rates, the

elimination of enormous price differentials, reforms of inefficient fiscal policies and of trade and customs procedures, adoption of an appropriate exchange regulation as well as realistic import and pricing policies. Monetary and fiscal measures are also necessary for making adjustments in the economy in order to fight inflation and the problems of the parity of the national currency with those of neighbouring countries in order to maintain real purchasing power. As it was underlined, currency overvaluation is one of the main causes of currency trafficking and smuggling.

40. Taking into account these factors, it would be worth recommending that at the national, sub-regional and regional levels, the following policies be examined:

(i) Streamlining the activities of the existing economic groupings by ensuring specialization in defined sectors and providing for regular consultations in order to implement all the clauses of the treaties of sub-regional groupings and, in particular, giving a high priority rank to the creation of multinational production and marketing corporations.

(ii) Establishing long-term purchasing and supply agreements on foodstuffs and primary materials and developing countertrade in order to reduce to the minimum expenditure of convertible currencies; undertaking, on a priority basis, joint research on the supply of and demand for products in each sub region in Africa with a view to adopting appropriate production and supply policies.

(iii) Cooperating fully with a view to creating a sub-regional and regional network of trade information through the exchange of information, encouraging and facilitating the free movement of African traders and businessmen.

(iv) Liberalizing, if possible, the exchange control and allocation system in order to allow importation of essential products. When the national currency is unstable, the possibility of establishing a system guaranteeing balance between the supply of and demand for foreign exchange within the framework of inter-State trade cooperation.

(v) Within the framework of an African Monetary Fund of which the acceleration modalities for its establishment process will be discussed soon by the African Ministers of Finance at their third meeting in Blantyre, Malawi, from 27 February to 3 March 1989, promoting the stability of African currency through efficient stabilization policies, including notably exchange rate regimes, at the national, sub-regional and regional levels. This corroborates the concerns expressed in the meetings of the Group of Seven which were held recently in Washington about an acceptable base for systems of parities of the main currencies within the framework of a real reform of the international monetary system.

(vi) Once the African Monetary Fund is created, promoting the liberalization of exchange regulations in order to eliminate payment restrictions among African countries by favouring free convertibility of national currencies and by fixing parities, and facilitating the harmonization of clearing and payment arrangements presently in force in order to encourage cooperation and intra-African trade.